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OFFICE SUPREME COURT, U.S.
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No. 854

In the Supreme Court of the United States

OCTOBER TERM, 1960

LOS ANGELES TRUST DEED & MORTGAGE EXCHANGE, ET AL., *Petitioners*

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

ARCHIBALD COX,
Solicitor General,
Department of Justice,
Washington 25, D. C.

WALTER P. NORTH,
General Counsel,

DAVID FERBER,
Assistant General Counsel,

[illegible] KENNAMER, JR.,
[illegible] A. DUDLEY,
Attorneys,
Securities and Exchange Commission,
Washington 25, D. C.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 54-94) is reported at 285 F. 2d 162. The Findings of Fact and Conclusions of Law of the district court are reported at 186 F. Supp. 830.

JURISDICTION

The judgment of the court of appeals was entered on November 23, 1960. A timely petition for rehearing was denied on January 10, 1961 (Pet. App. 95-98). The petition for a writ of certiorari was filed on March 28,

1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the nationwide sale of notes secured by second trust deeds on land located in California, where the seller promised to collect and remit or reinvest the proceeds and otherwise to service the trust deed notes, constituted the sale of "investment contracts," and hence "securities," under the Securities Act and the Securities Exchange Act.

2. Whether, in an action brought by the Securities and Exchange Commission to enjoin violations of federal securities laws (including the fraudulent misuse of investors' funds), the court, upon finding that such violations had occurred and that the issuing corporation was insolvent, may appoint a receiver to conserve its assets and maintain the *status quo* pending compliance with the federal securities law or the institution of bankruptcy proceedings.

3. Whether alleged procedural errors at the trial (the shortening of the usual notice period for motions with respect to depositions, refusal to permit examination of Commission officials, and admission of certain evidence) denied petitioners a fair trial.

4. Whether the court below correctly held that charges of bias against the district judge were unsubstantiated.

STATUTES AND RULES INVOLVED

Section 20(b) and Section 22(a) of the Securities Act of 1933 are set forth at pages 99 and 100 of the appendix to the petition. Other pertinent sections

of the securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. 77a, *et seq.*, and the Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. 78a, *et seq.*, are set forth in the Appendix hereto, *infra*, pages 15 to 19.

STATEMENT

Petitioners were found to have engaged in the sale of unregistered securities in violation of the registration and anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. The illegal sales were made in connection with an investment plan called the "Secured 10% Earnings Program." The facts are set forth in the lengthy and detailed findings and conclusions of the district court, entered after a 37-day trial. (186 F. Supp. 830, 839-890).

While the plan varied in minor detail from time to time, its essential character remained unchanged. Petitioners promised investors depositing moneys under their program 10% earnings from the purchase of discounted notes secured by second trust deeds on California real estate. Petitioners undertook to "service" the trust deed notes for the investors. Such services included, *inter alia*, making monthly, quarterly or other periodic collections from trustors, remitting or reinvesting earnings, sending out delinquency notices and, where necessary, carrying out foreclosure procedures (186 F. Supp. at 846). Petitioners' profit was to be derived from the difference between the price they paid for the trust deed notes and the price at which they were sold to investors—both prices being below the face amount of the notes (186 F. Supp. at 843-848).

Investors in the program were given a portfolio containing copies of a note, a trust deed and assignment thereof, a policy of title insurance and an engraved Certificate of Registration and Ownership which was designed to resemble an engraved share of stock or a bond (186 F. Supp. at 848-849).

Although petitioners represented in their sales literature that the trust deeds were "seasoned," "prime," and "trouble-free" and had been carefully screened and appraised (186 F. Supp. at 850), they placed in investors' accounts with petitioner Los Angeles Trust Deed & Mortgage Exchange ("LATD") highly speculative trust deeds, created for the most part against units of unimproved, vacant land (186 F. Supp. at 849-852). In addition, by holding title as trustee to "service" many of the trust deeds (186 F. Supp. at 849) and by other devices, petitioners completely controlled these trust deeds and used this controlling position to petitioners' advantage and to the detriment of investors. Thus, in certain cases where the makers of the notes liquidated them in advance of the maturity date, petitioners appropriated the resulting "windfall" profits properly belonging to the investors (186 F. Supp. at 876-879).

To induce investment in the enterprise, petitioners promised investors a 10% return even before their funds would be invested in trust deeds. They represented that money deposited by the twentieth of the month would "earn" a 10% return from the first of the month. If, before a trust deed was assigned to an investor, he elected to receive his "earnings" monthly, petitioners would reduce the investor's ledger account on the books of petitioner LATD by an amount equal

to the "earnings" payment (186 F. Supp. at 878-879).

Further to assure the continued influx of investors' funds necessary to sustain the enterprise, petitioners formulated a policy of taking back defaulted trust deeds, so that they could claim that no investor had ever suffered a loss. This policy resulted in a continuous increase in inventory of a large quantity of unsaleable trust deeds (186 F. Supp. at 860). These defaulted trust deeds taken back from investors were carried on petitioners' books not at their cost but at the inflated prices at which they had been repurchased from the dissatisfied investors (186 F. Supp. at 862). Thus, as of March 31, 1959, after necessary accounting adjustments in the balance sheet of petitioner LATD, including an adjustment to reduce inventory of trust deeds from the inflated value at which they were carried, that petitioner was insolvent in the bankruptcy sense (186 F. Supp. at 861-865).

Petitioners sent out elaborate brochures through the mails to tens of thousands of investors from whom essential facts were withheld (186 F. Supp. at 872). In addition, investors were sent monthly statements of their accounts, which were designed to mislead them into believing that their accounts were growing in value, when, in fact, the amounts shown on the monthly statements were merely "projected" earnings representing no realizable value (186 F. Supp. at 878-879). Petitioners concealed their fraud and the precarious financial condition of their enterprise through the issuance of misleading financial statements (186 F. Supp. at 868).

Based on the foregoing findings, the district court entered a decree enjoining the petitioners from violat-

ing the registration and fraud provisions of the Securities Act and the Securities Exchange Act.[1] The court also appointed a receiver to liquidate the assets of LATD and of Trust Deed & Mortgage Markets (a separate corporation operated as a department of LATD), so that investors' funds would be adequately protected and the rights of investors equitably determined (186 F. Supp. at 890).

The court of appeals upheld the injunction, but modified the scope of the receivership. The court held that, under the tests formulated by this Court in *Securities and Exchange Commission* v. *Joiner Corporation*, 320 U.S. 344, and *Securities and Exchange Commission* v. *W. J. Howey Company*, 328 U.S. 293, petitioners were not merely engaged in the sale of real estate trust deeds, but were in fact offering and selling investment contracts within the meaning of Section 2(1) of the Securities Act and Section 3(a)(10) of the Securities Exchange Act (Pet. App. 57-71). It further ruled that the petitioners had violated the anti-fraud provisions of those Acts (Pet. App. 71). Although the court upheld the appointment of a receiver as necessary for the protection of investors, it eliminated the direction that the receiver should liquidate the enterprise (Pet. App. 87-94). It stated (Pet. App. 93) that "[t]he trustee in bankruptcy is the person to liquidate, if that be necessary, under the usual and ordinary supervision of a Referee in Bankruptcy":

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[1] Previously, the district court had entered a preliminary injunction enjoining petitioners from violating these same sections and had appointed a receiver. The court of appeals had set aside those orders of the district court and remanded the matter for trial. Pet. App. 1-28; 264 F. 2d 199.

and that "the receiver here should be regarded as one pendente lite."

Following the entry of the judgment of the court of appeals and prior to the filing of the petition for a writ of certiorari, petitioners LATD and Trust Deed & Mortgage Markets were adjudicated bankrupts on December 19, 1960. The adjudication was made with their consent, on a petition filed by certain of their creditors. These two petitioners, therefore are now under the jurisdiction of the bankruptcy court, and are in process of liquidation. See *In re Los Angeles Trust Deed and Mortgage Exchange* (S.D. Calif., Cen. Div., Bankruptcy No. 118, 178-MC). The bankruptcy court has not authorized the filing of the petition for a writ of certiorari by these petitioners and the petition is not filed on behalf of the trustee in bankruptcy.

ARGUMENT

1. In holding that petitioners were selling investment contracts, the courts below correctly applied to the facts of this case the definitions of an investment contract formulated by this Court in *Securities and Exchange Commission* v. *Joiner*, 320 U.S. 344 and *Securities and Exchange Commission* v. *W. J. Howey Company*, 328 U.S. 293. In *Joiner*, the Court held that sales of leaseholds in specific portions of a tract of potential oil and gas land to widely scattered purchasers, coupled with the promoter's representation that it would drill an exploratory well to prove the potentiality of the tract, constituted sales of investment contracts within the purview of the Securities Act. The Court said (320 U.S. at 352-353):

> The test [in determining whether a security is involved] * * * is what character the instrument is

> given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. *In the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be.* [Emphasis added.]

The principle inherent in *Joiner*, that an investment contract may be created without the investors sharing collectively or *pro rata* in the profits to be derived from an enterprise, was reaffirmed in *Howey*. There, individual orange tree groves were offered, together with contracts for their cultivation and harvests and sale of the produce. As noted by the Court of Appeals in that case, each purchaser looked to the "fruitage of his own grove and not to the fruitage of the groves as a whole."[2] As in *Joiner*, this Court, after examining the circumstances surrounding the sale of the groves, concluded that what was being sold was something more than fee simple interests in land, namely, an investment opportunity for profit to persons residing in distant localities. It said (328 U.S. at 300):

> Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involved investment contracts, regardless of the legal terminology in which such contracts are clothed.[3]

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[2] *Securities and Exchange Commission* v. *Howey Company*, 151 F. 2d 714, 717 (C. A. 5), reversed, 328 U. S. 293.

[3] Both the *Howey* and *Joiner* cases make clear that the term "investment contract," which prior to the adoption of the Securities Act also had been included in the definition of security in many

Similarly in the present case it was found that petitioners offered and sold something more than an interest in a note secured by a second deed of trust on real estate. Petitioners promised and investors were led to expect continuous 10% earnings on their moneys because of (a) petitioners' ability to select, screen, appraise and acquire suitable trust deeds; (b) their servicing and collection of loans; (c) their handling of foreclosures, if necessary, or their repurchase or resale of notes of dissatisfied investors. In addition, petitioners impliedly guaranteed against loss of investment[4] (186 F. Supp. at 887). Many investors depositing funds with petitioners lived far from the lands which secured their investment and, therefore, could not themselves service their investment (*ibid.*). They were dependent upon the promoters to make the investment opportunity feasible and valuable. The court of appeals thus correctly held that petitioners and investors were engaged in a common enterprise, since the investors had an economic interest "inextricably woven with the ability of LATD to locate by the exercise of its independent judgment a sufficient number of discounted trust deeds, and the ability of LATD subse-

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state blue sky laws, has continuously been utilized to cover transactions in which the investor looks to the efforts of the managers of the enterprise for success of his investment. See cases discussed in *Securities and Exchange Commission* v. *Joiner*, 320 U.S. at 352, note 10, and *Securities and Exchange Commission* v. *W. J. Howey Company*, 328 U.S. at 298-299.

[4] Petitioners refer to and quote from (Pet. 20-22) Plaintiff's Exhibit 32, a sales brochure used by petitioners to induce investments. As petitioners point out, this particular brochure was used since February 1959. But petitioners fail to note that it is a brochure that was revised to meet certain of the charges arising from this suit, which was instituted early in February of 1958. Earlier brochures did not contain the quoted language.

quently to meet its commitments, to check, evaluate, supervise, and supersede" (Pet. App. 70).

The judgment below may, in large part also be sustained on the alternative ground that, whether or not petitioners were selling "investment contracts," the notes they were selling were themselves "securities." Section 2(1) of the Securities Act defines the term "security" to include "any note" and "any evidence of indebtedness," and Section 3(a) (10) of the Securities Exchange Act defines "security" to include "any note." The district court's findings of violations were based not only upon sales of investment contracts, but also upon the sales of the underlying trust deed notes. 186 F. Supp. at 886-887. Since the violations found with respect to the notes involved only the anti-fraud, and not the registration, provisions of the Acts, those violations might not support paragraph I of the injunction, prohibiting the sale of unregistered securities; nor would they support paragraph V prohibiting the corporate petitioners from acting as brokers or dealers without registration. (186 F. Supp. at 834, 837-838). They do, however, clearly support all the other provisions of the judgment (directed against petitioners' fraudulent activities), including the receivership.

2. The court of appeals eliminated the direction in the order of the district court that the receiver was to liquidate the two corporate petitioners, on the ground that "[t]he trustee in bankruptcy is the person to liquidate, if that be necessary," and that the receiver was to be "one pendente lite" (Pet. App. 93). Since these petitioners have now been adjudicated bankrupts, however, and a trustee in bankruptcy has been appointed to liquidate them, the receivership pendente

lite has been superseded. Accordingly any issue as to whether the courts below properly placed them in receivership is moot. Moreover, there is a serious question whether these petitioners may now seek review, since the bankruptcy court has not authorized such action and the petition in their behalf is not filed for the trustee. Section 11(*c*) of the Bankruptcy Act, 11 U.S.C. 29(c).

In any event, the court below correctly sustained the appointment of the receiver. The Commission's suit invoked the equitable powers of the district court pursuant to Section 22(a) of the Securities Act[5] and Section 27 of the Securities Exchange Act. The receivership, as modified by the court of appeals, was ancillary to the injunction and appropriate to effectuate the purpose of those Acts of affording full protection to investors. Cf. *Mitchell* v. *DeMario Jewelry*, 361 U.S. 288, 291; *Porter* v. *Warner Holding Company*, 328 U.S. 395, 398; *Aldred Investment Trust* v. *Securities and Exchange Commission*, 151 F. 2d 254, 260-261 (C.A. 1). It was justified by (1) the flagrant nature of the fraud found, including the misuse of investors' funds deposited with petitioners, and (2) the finding that, as of March 31, 1959, petitioner LATD was insolvent in the bankruptcy sense. In these circum-

[5] Petitioners' discussion of Section 20(b) of the Securities Act (Pet. 4, 9, 25-28) confuses the authorization in that section, empowering the Commission to institute injunctive actions, with the provisions of Section 22(a), granting jurisdiction in the district courts to adjudicate *all suits* "in equity and actions at law brought to enforce any liability or duty created" under the Act. *Deckert* v. *Independent Shares Corporation*, 311 U. S. 282, relied upon by petitioners on this point, held, as petitioners state, that Section 22(a) of the Securities Act governs private actions under the Act. But that determination does not mean that injunctive suits brought by the Commission are not also governed by Section 22(a).

stances, it was proper to remove the investors' funds from petitioners' control, and thus prevent further abuse.

Contrary to petitioners' contention (Pet. 23-25), the decision below is not in conflict with *Gordon* v. *Washington*, 295 U.S. 30, and *Kelleam* v. *Maryland Casualty Co.*, 312 U.S. 377. Those cases hold that a federal court should not appoint a receiver unless it is ancillary to some other relief. Here, as we have shown, the appointment was ancillary to the injunction.

3. Petitioners' claims of procedural errors which allegedly denied them a fair trial (Pet. 11-17) are essentially (a) that the trial court should not have shortened the usual notice period for motions with respect to depositions, (b) that it should have permitted petitioners to examine officials of the Securities and Exchange Commission to prove such matters as that "never in the history of the SEC had it ever accepted for registration, or considered available for registration, single trust deeds or mortgages, such as petitioners were dealing in" (Pet. 15) and (c) that certain exhibits offered in evidence by the Commission should have been excluded, specifically a schedule prepared by Commission investigators based upon petitioners' records. But these were matters primarily within the discretion of the trial judge, and there is no showing that the latter's rulings were erroneous. Moreover, such minor alleged errors during a 37-day trial obviously did not deny petitioners a fair trial.[6]

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[6] For a discussion of the petitioners' contumacy in opposing pretrial discovery, see *Securities and Exchange Commission* v. *Los Angeles Trust Deed & Mortgage Exchange*, 24 F.R.D. 460 (S.D. Calif.).

4. The court of appeals carefully considered all of petitioners' charges of bias on the part of the district judge and determined that they were without substance. Petitioners' Question 6 (Pet. 5, 10-11) and the discussion thereof (Pet. 29-33) misconstrue the decision of the Court of Appeals. Contrary to the petitioners' assumption that that court "tacitly" conceded "evidence of bias and prejudice" on the part of the trial judge (Pet. 29), the court stated only that certain remarks charged to have been made informally in chambers by the trial judge "would have been better left unsaid." It held, however, that the alleged statements did not prevent a "fair trial," and that petitioners' affidavits provided "no evidence of bias in the personal sense contemplated and required by the statute" (Pet. App. 74).

Petitioners' Question 5 (Pet. 4-5, 10) and the discussion thereof (Pet. 28) are irrelevant since petitioners discuss a procedure that was not followed below, *i.e.*, the filing of a counter-affidavit by a district judge to an affidavit of bias and prejudice under 28 U.S.C. 144. The opinion of the court of appeals makes clear that it gave careful consideration on appeal to the validity of the petitioners' affidavits—the very procedure which the cases cited by petitioner suggest should be followed.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

ARCHIBALD COX,
Solicitor General.

WALTER P. NORTH,
General Counsel,

DAVID FERBER,
Assitant General Counsel,

F. E. KENNAMER, JR.,
JOHN A. DUDLEY,
Attorneys,
Securities and Exchange Commission.

APRIL, 1961.

APPENDIX

Securities Act of 1933

(48 Stat. 74, as Amended, 15 U.S.C. 77a, et seq.)

SEC. 2. When used in this title, unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt, for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

* * *

SEC. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

* * *

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate com-

merce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

SEC. 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Securities Exchange Act of 1934

(48 Stat. 881, as Amended; 15 U.S.C. 78a, et seq.)

SECTION 3. (a) When used in this title, unless the context otherwise requires—

* * *

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment con-

tract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

SECTION 15. (a) No broker or dealer (other than one whose business is exclusively intrastate) shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer is registered in accordance with subsection (b) of this section.

* * *

(c) (1) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

* * *

SECTION 27. The district courts of the United States, and the United States courts of any Territory or other

place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duly created by this title or rules and regulations thereunder, or enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 225 and 347). No costs shall be assessed for or against the Commission in any proceeding under this title brought by or against it in the Supreme Court or such other courts.

Rule Under the Securities Exchange Act of 1934

(17 CFR 240.15cl-2)

Rule 15cl-2. Fraud and misrepresentation.

(*a*) The term "manipulative, deceptive, or other fraudulent device or contrivance," as used in section 15 (*c*) (1) of the act, is hereby defined to include any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

(*b*) The term "manipulative, deceptive, or other fraudulent device or contrivance," as used in section 15 (*c*) (1) of the act, is hereby defined to include any untrue statement of a material fact and any omission

to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading.

(c) The scope of this section shall not be limited by any specific definitions of the term "manipulative, deceptive, or other fraudulent device or contrivance" contained in other rules adopted pursuant to section 15(c) (1) of the act.

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